



MICHAEL J. MURPHY
State Treasurer

Third Quarter 2004

The QUARTERLY

Local Government Investment Pool

Will the Fed pause from hiking rates?

In an act widely considered to be part of its "measured move," and without any element of surprise, the Fed raised its targeted funds rate by 25 basis points (bp) from 1.50 to 1.75 percent during the September FOMC meeting.

The Fed has clearly conveyed its intentions to bring back neutrality in monetary policy. It has also reiterated its goal to respond to the changing economic environment and fulfill its obligation to maintain price stability.

Notable changes to the FOMC statement were remarks on output growth regaining some traction after early slippage and labor growth improving modestly. The Fed noted that inflation expectation has eased somewhat despite higher oil prices. The risk assessment by the Fed remained balanced.

Some Fed members have voiced concern about the state of job creation in the aftermath of the September labor market report. Dallas Governor McTeer said "... that the (Fed) may be coming to the point where future policy moves will become data dependent," and Fed member Bernanke said "... if a slowing of the economy justifies a pause that certainly will be the response." The Fed is clearly keeping a close watch on current developments in the labor market as this area has been suspect since the start of the year.

Oil and inflation

The economy is growing at a rate that might put GDP growth in the vicinity of 4 percent for the third quarter after a 3.3 percent rise in the April-June period. Consumer spending has been stellar once again after hitting a soft patch during the second quarter. The initial shock of higher oil prices affected retail sales

at the outset when gas prices reached \$2/gallon but tapered off as consumers trekked back to stores in a quiet fashion.

Since then, oil prices have moved above \$50/barrel due to hurricanes in the gulf coast, violence erupting in Nigeria, and OPEC operating at full capacity. There is an impending threat that this phenomenon could slow down not only the U.S. economy but the global economy as well. The market has been worried about the output-reducing effects of higher oil prices. Fed Chair Greenspan mentioned in a recent speech that higher oil prices could potentially shave 0.75 percent off of the GDP, but warned that further "material" rise in oil could pose a serious threat.

Oil shortages are occurring at a time when global demand for energy has risen more than market forecasters expected. China has been ramping up production as its economy continues its double-digit growth. The high oil prices could derail growth if consumers hunker down from spending, and if higher gas prices stoke inflation. The good news is there has been no evidence of acceleration in core inflation. Fed member Thomas Hoenig issued a statement that a \$50/barrel oil price is still consistent with growth of 3.5-4 percent in the U.S. economy. Greenspan has indicated that recent oil production disruptions are still temporary in nature and have been the result of growing uncertainties about the long-term security of world oil production. *Greenspan said he does not expect oil prices to trigger inflation.*

Inflation has been subdued as core PCE prices have maintained a 1.4 percent level following a 1.5 percent high in June. The continued

continued on page 2

LGIP staff

Michael J. Murphy
State Treasurer
(360) 902-9001

Michael Colleran
Assistant Treasurer
(360) 902-9002

Douglas Extine
Deputy Treasurer
(360) 902-9012

Lisa Hennessy
Investment Officer
(360) 902-9013

Jen Thun
LGIP Administrator
1-800-331-3284

Mary Pheasant
Administrative Support
(360) 902-9004

www.tre.wa.gov

Market summary

from page 1

slack in production, which was mentioned by the Fed several times during meetings, could explain the absence of price pressure even at a time when energy prices are recording all-time highs. U.S. productivity has generated higher business profits, cushioning increases in labor costs.

An important caveat in core inflation pickup is that of accelerating unit labor costs. The economy may be able to stave off increases if hiring conditions remain moderate. Job creation has been growing at a respectable rate but conditions for huge increases are still remote. A recent Challenger Grey outplacement survey reported 108,000 layoff announcements by U.S. companies in September, a 45 percent increase. Although it is premature to reach any conclusion about the job market, surveys like these highlight the precarious situation of the U.S. labor market. Labor cost inflation will remain in check if job creation is still tentative.

Non-farm payrolls

The recent labor market has shown that momentum has been waning with only a 96,000 increase in non-farm payrolls in September 2004, which was less than an expected increase of 150,000. Most of the jobs created came from the government sector as only 37,000 new jobs were from the private sector. Average hourly earnings rose by a mere 0.2 percent, and manufacturing jobs suffered a decline of 18,000. However, the unemployment rate remained constant at 5.4 percent due to a lower labor participation rate. The Bureau of Labor Statistics acknowledged the hurricanes that battered Florida but suggested that it was not material enough to change the jobs assessment. Bad weather and higher energy prices were the main factors cited for the negative surprise. It is unclear if oil prices will eventually derail economic growth. Nonetheless, economists were optimistic that the economy could still register an above-trend growth rate of 4-4.50 percent GDP for the whole year.

Economic growth

The Fed meets, and could potentially raise rates, in November and again in December. If the growth rate slows, will the Fed pause from raising rates? At this point it appears that it will stop tightening once it achieves a "neutral rate", which Fed officials believe is in the vicinity of 3-5 percent. However, the neutral rate seems to be a moving target as all the variables involved in estimating this number have exhibited considerably mixed signs in the last quarter.

Inflation, economic growth, and productivity have offered conflicting signals. Inflation has been behaving properly but for how long? Oil prices have yet to show any damaging effects on inflation. While productivity has slowed from its peak rate and economic growth has been robust, many wonder if the continued assault on energy costs could put the whole growth thesis into a correction mode.

Business capital spending has taken over from consumption as the growth engine. It has averaged twice that of the real GDP growth for the past four quarters. Capacity utilization has been rising and most firms have shown considerable appetite to invest. Firms have indicated that the rise in their investment was only a function of depressed levels during the recession, and net investment still has some catching up to do just to return to normal. Another driver for increased optimism is the relative rise in global demand.

Consumers have moderated their spending without the stimulus of further tax cuts. With inflation and interest rates still low, consumer spending continued at a rate equal to income growth. However, consumer sentiment has significantly dropped in October. Demand growth might stay stagnant in the near future as income grows slowly amid low personal savings rates. Energy prices could also be affecting consumers' perception of the negative repercussions of higher oil prices. The economy needs to see more significant income growth before this sector again takes

continued on page 3

LGIP Advisory Committee

Dani Burton

Klickitat County Treasurer
(509) 773-4664

Stan Finkelstein

Assn. of Washington Cities
(360) 753-4137

Lisa Frazier

Mason County Treasurer
(360) 427-9670 (Ext 484)

Chuck Greenough

State Board for Community and Technical Colleges
(360) 704-4380

Paula Henderson

City of Des Moines
(206) 870-6512

Lynn Hills

Port of Bremerton
(360) 674-2381

Richard Patrick

City of Burlington
(360) 755-0531

Shelley Pearson

Kitsap Co. Investment Offcr.
(360) 337-7139

Barbara Stephenson

Kitsap County Treasurer
(360) 337-7136

Dan Underwood

City of Richland
(509) 942-7302

Linda Wolverton

Spokane County Treasurer
(509) 477-4786

Mark Wyman

Snohomish County PUD
(425) 783-8317

Market summary

continued

the lead as the biggest contributor to the GDP.

The bond market

Bond yields declined in the wake of lower non-farm payrolls and, in part, because of the outlook that economic growth might stall due to higher oil prices. Investors were speculating that the Fed might pause from raising rates this year and stop at a 2 percent fed funds rate. Most investors employed yield flatteners to take advantage of the perceived slowing of economic momentum. All eyes were on the 10-year bond yields, which traded below 4 percent and briefly reached as low as 3.95 percent. A drop below 4 percent was a reminder to traders that exposure to mortgage refinancing plays had the potential for hedgers to buy back the market. Ten-year bond yields have been stuck in a 4-4.25 percent range during the quarter.

Two-year Treasury notes have also traded in a range between 2.40 and 2.70 percent for the entire quarter. The curve flattened during the quarter, resulting in underperformance of the 2-year vs. the 5- and 10-year sectors. The front-end of the yield curve still expects a rate hike by year-end, although the possibility

of two hikes to bring the fed funds rate to 2.25 percent has become less likely. This can be seen by looking at fed fund futures, which imputed a 100 percent certainty at the start of the quarter and ended the quarter at nearly a 25 percent probability. Weak economic numbers and the rising oil prices have dampened investor outlook.

In contrast to the longer end, the short end of the yield curve rose sharply during the quarter. Yields on 3-month treasury bills rose from 1.21 percent in July to 1.70 percent in September. In similar fashion, yields on 6-month bills started the quarter at 1.60 percent and ended at nearly 2 percent.

The LGIP

As the targeted fed funds rate rose during the quarter so did net returns on the LGIP. The LGIP net return climbed from 1.19 percent in July to 1.34 percent in August and ended the quarter at 1.55 percent. In anticipation of the Fed's rate hikes, and in an effort to reprice the portfolio as quickly as possible, the LGIP's average life was held at approximately 35 days throughout the period. The LGIP continues to maintain a short average life in anticipation of possible further rate hikes.

**Also offered by the
Office of the State
Treasurer. . .**

LOCAL Program

Financing solutions for local government equipment and real estate needs.

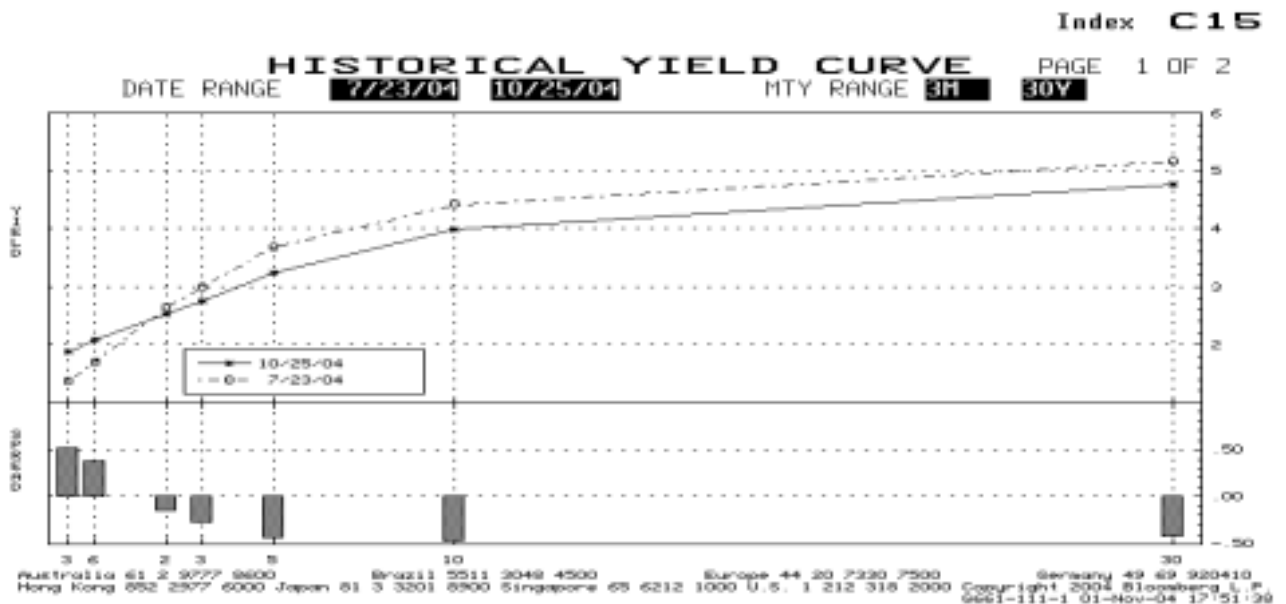
[www.tre.wa.gov/
local.htm](http://www.tre.wa.gov/local.htm)

Contacts:

Sue Melvin
Equipment specialist
360-902-9022

Kristi Wolgamot
Real estate specialist
360-902-9020

Pam Johnson
LOCAL specialist
360-902-9021



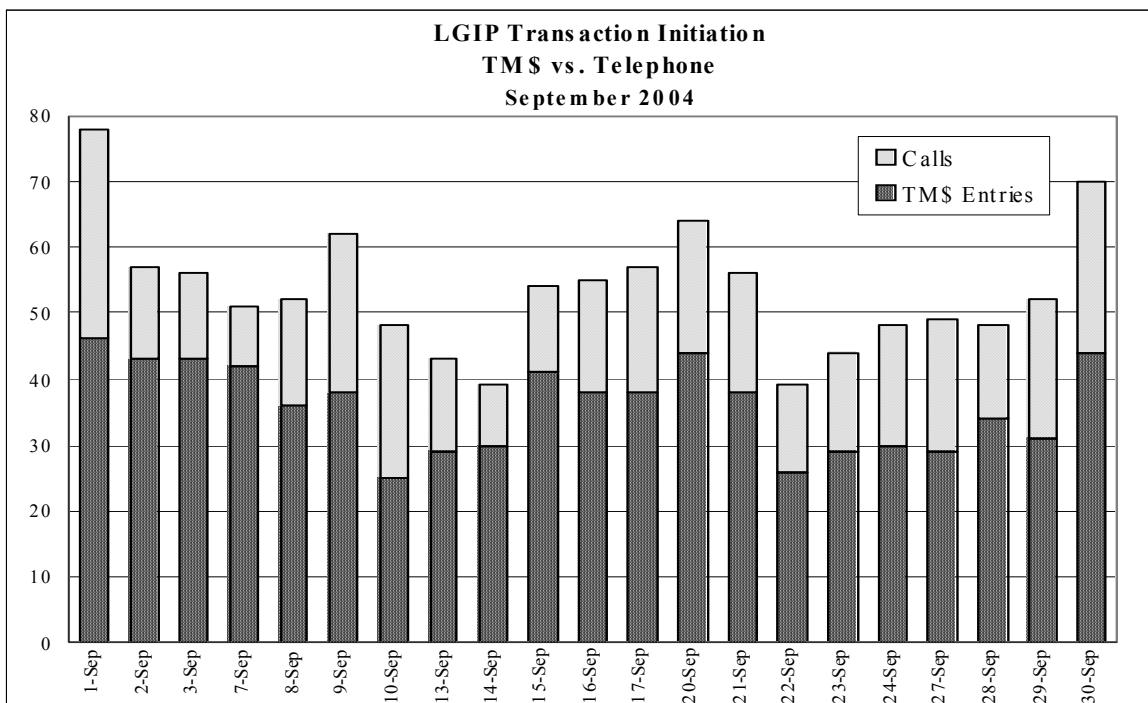
LGIP fund balance and transaction activity

By Jen Thun

This quarter I thought I'd give you a glimpse of LGIP activity during a typical month. Of course you know your own LGIP activity, but have you ever wondered what all LGIP activity – more than 420 participants – looks like as a whole?

Transaction initiation

First let's look at the number of transactions and the way they are initiated. In September approximately 67 percent of daily LGIP transactions were initiated using TM\$. The graph below compares the number of transactions initiated by TM\$ versus the telephone during the month.

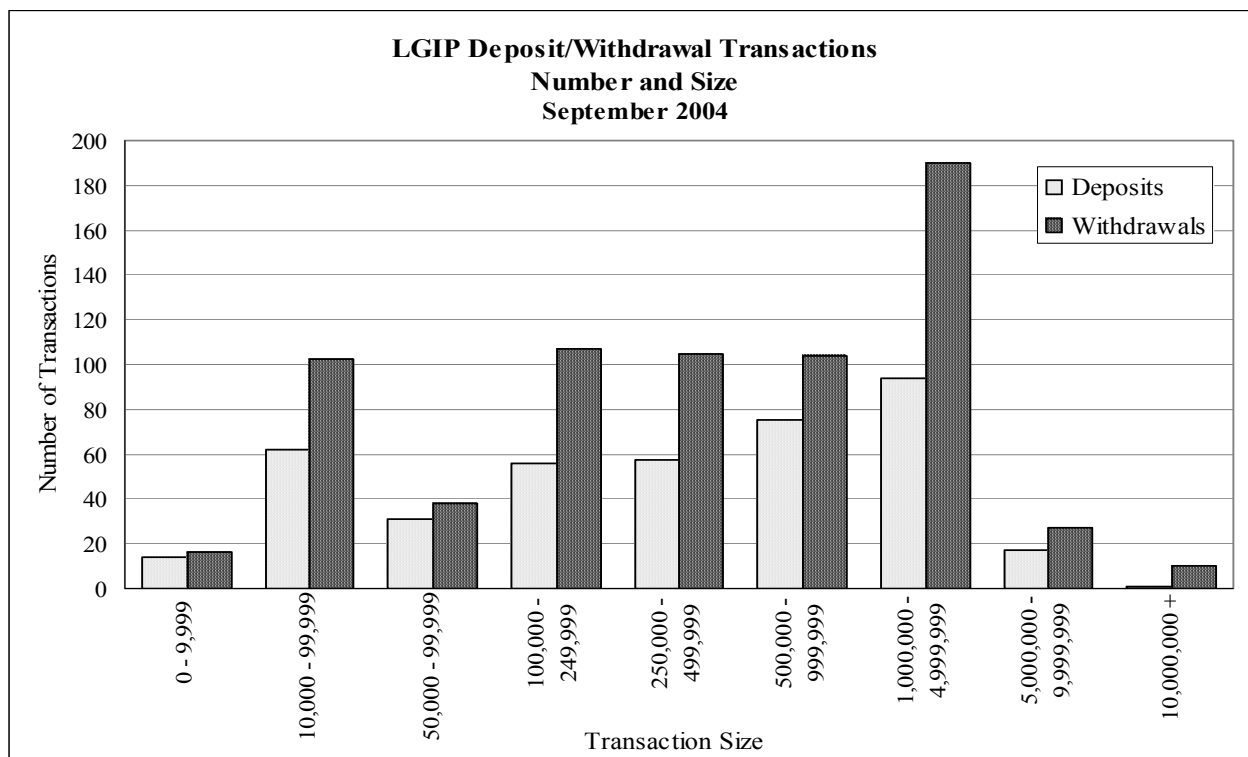


Notice that on Sept. 10 there were just 25 TM\$ entries and 23 phone calls, resulting in a low of 52 percent of transactions initiated via TM\$. However, on Sept. 7 there were 42 TM\$ entries and only nine calls, for a high of 82 percent of transactions initiated via TM\$. On an average, there were 53 transactions per day in September – 36 initiated via TM\$ and 17 by phone.

Transaction number and size

Now here's a look at the size of the deposit and withdrawal transactions. On page 5 is a graph showing amount ranges and the number of deposits and withdrawals in each range. There were 1,106 transactions during September -- 407 deposits and 699 withdrawals.

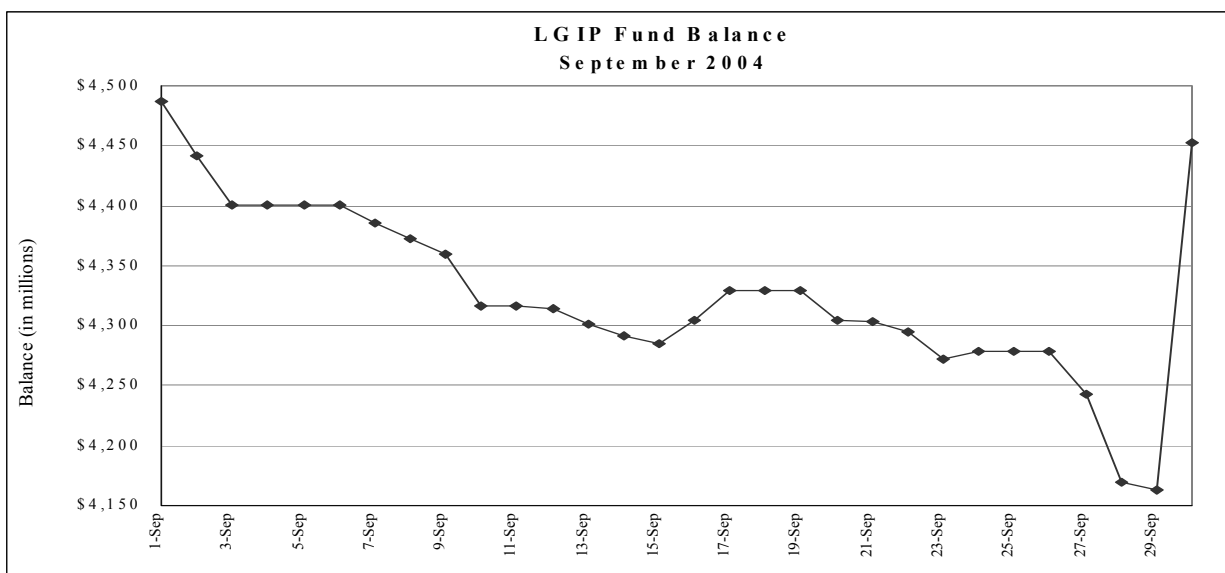
continued on next page



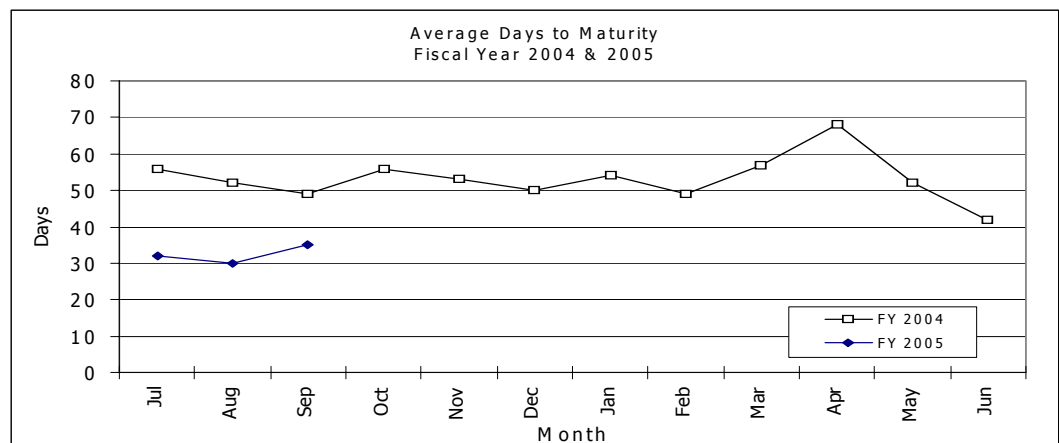
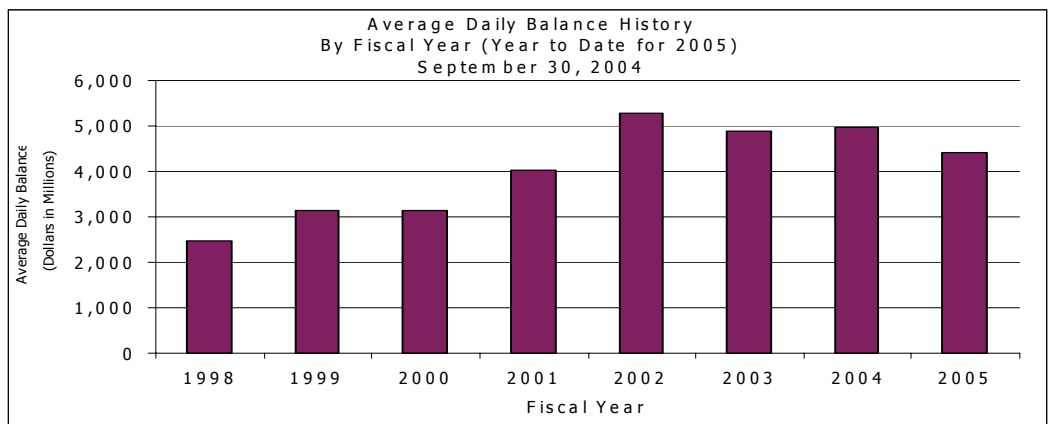
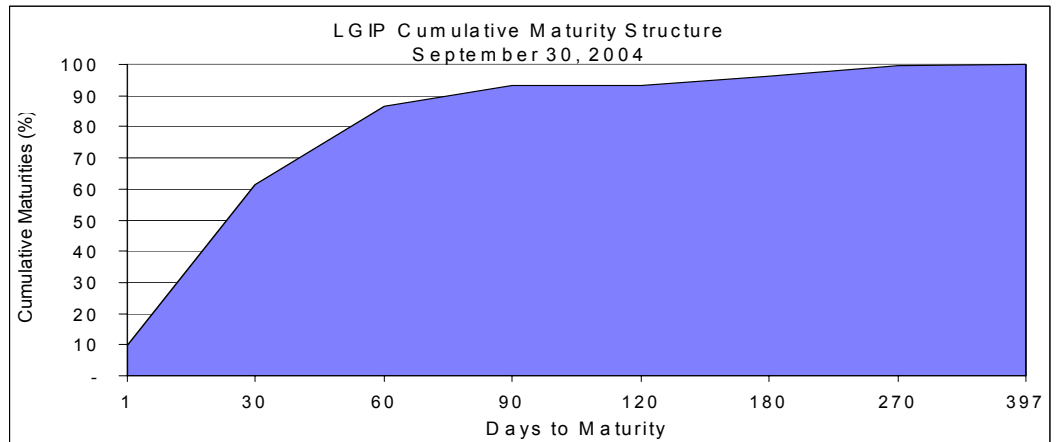
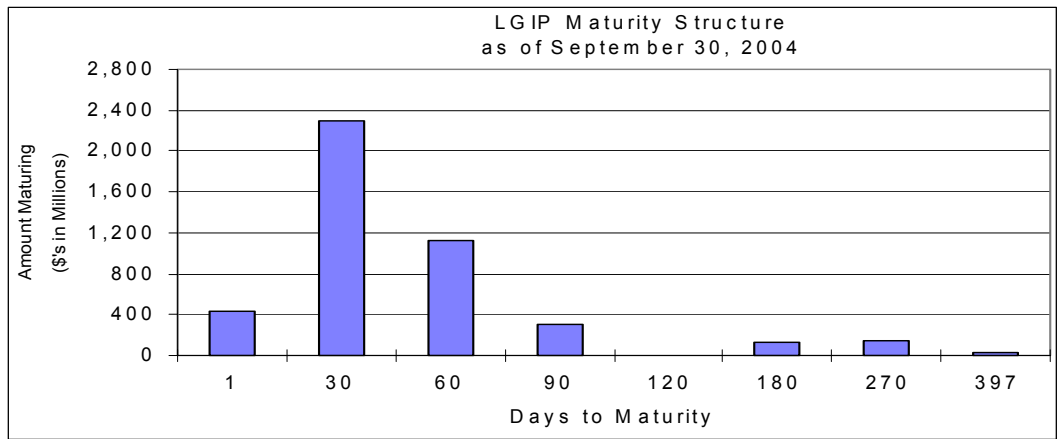
From the graph you'll notice that the largest percentage of deposits and withdrawals are between \$1,000,000 - \$9,999,999 – 25 percent of deposits and 29 percent of withdrawals are in this range.

Fund balance

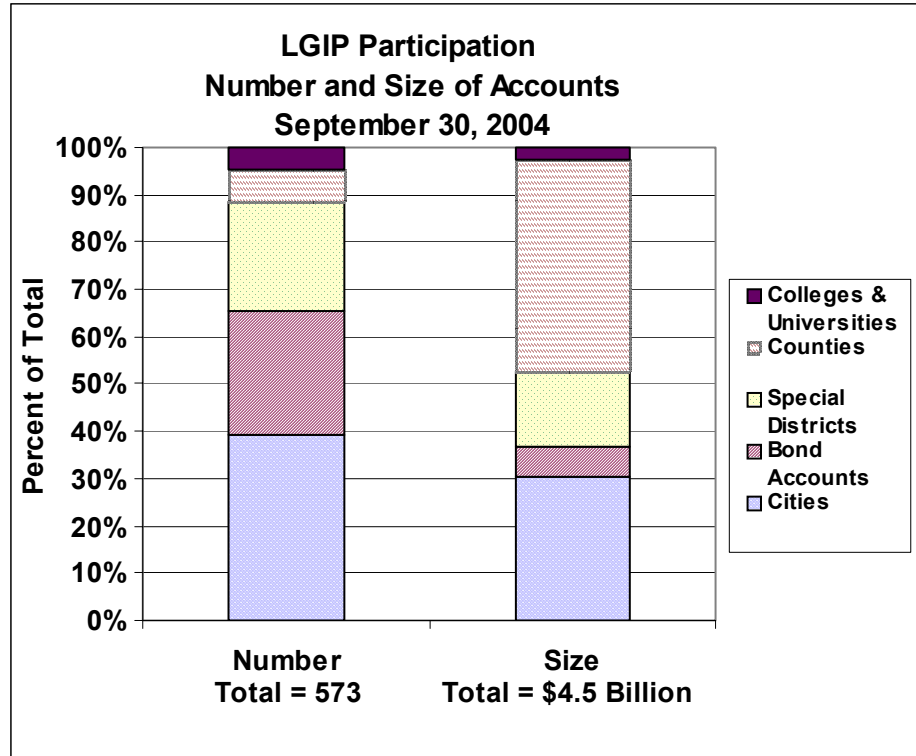
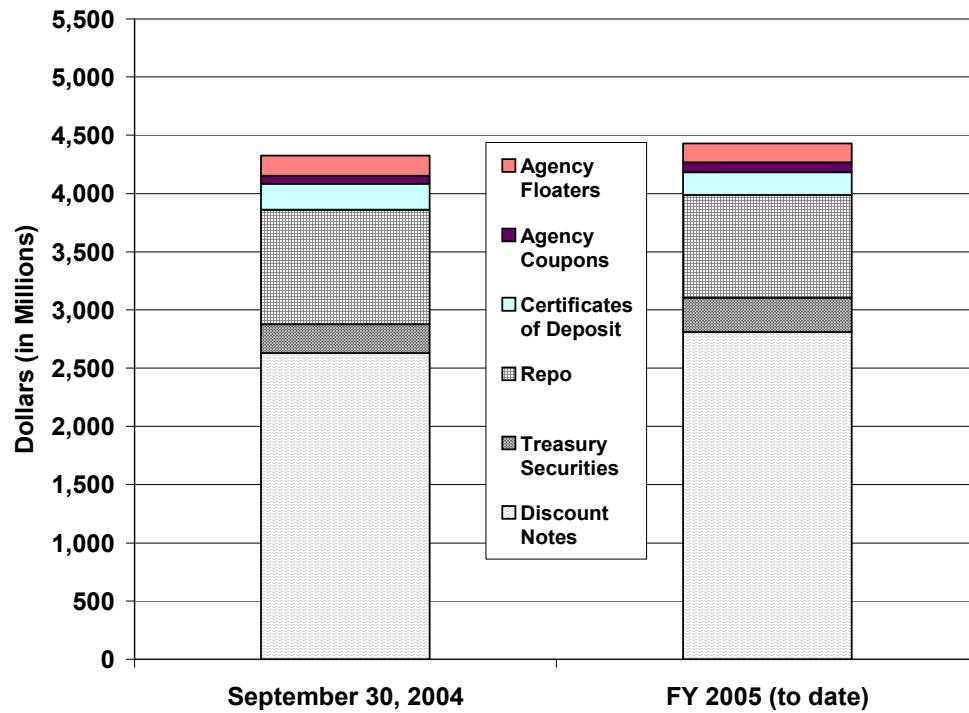
And finally, here's a glance at the LGIP fund balance. This last graph illustrates the changes in the LGIP fund balance during September.



continued on page 8



Portfolio Composition Average Balance by Security Class



LGIP Fund Balance and Transaction Activity

from page 5

The average daily balance in September was \$4.3 billion. The fund began the month at a high of \$4.5 billion, steadily worked to a low of \$4.1 billion by Sept. 29, and ended with a jump back up to \$4.4 billion on Sept. 30. This pattern, a high beginning balance declining during the month then ending with an upsurge, is typical of LGIP monthly fund balance activity.

I hope this helps to give you a broader perspective of LGIP activity as a whole. If you have any questions about this information, or if you are interested in other LGIP data, please feel free to call me at 1-800-331-3284.

One last note – be sure to check the LGIP holiday schedule posted below. There are three LGIP holidays that are not banking holidays – November 26, December 24, and December 31. Please keep these in mind when planning your LGIP activity.

LGIP Holiday Schedule for 2004 and 2005

The Local Government Investment Pool will be closed on the following days:

2004

Thurs	November 11	Veteran's Day
Thurs/Fri	November 25-26	Thanksgiving holiday
Friday	December 24	Christmas
Friday	December 31	New Year's

2005

Monday	January 17	Martin Luther King's Birthday
Monday	February 21	Washington's Birthday
Monday	May 30	Memorial Day
Monday	July 4	Independence Day
Monday	September 5	Labor Day
Monday	October 10	Columbus Day
Friday	November 11	Veteran's Day
Thurs/Fri	November 24-25	Thanksgiving holiday
Monday	December 26	Christmas

Notes from the October 15 advisory committee meeting

The LGIP Advisory Committee met October 15. Treasurer Murphy stated that an audit of the LGIP is performed annually by an outside CPA firm. A brief history was given regarding how the process was changed in 2002 from having the State Auditor's Office perform a portion of the audit to selecting a private firm to perform the entire audit. Ray Holmdahl from Peterson Sullivan PLLC, the CPA firm that was selected to perform the audit, gave a brief overview of their responsibilities as a CPA firm and what is included in the audit. The field work has been completed, no audit adjustments were found, and the final report will be issued soon.

The Government Finance Officers Association has awarded the Certificate of Achievement of Excellence in Financial Reporting to the LGIP for the Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2003.

A brief update was given on the net LGIP returns for July through September. The rates

have been increasing as the FOMC has raised the fed funds rate by 25 basis points (bp) at each of the last three meetings. The gross rate in October is expected to be about 1.72 percent. The LGIP has outperformed its benchmark, iMoneynet, Inc., by an average of 40 basis points.

The strategy for the management of the LGIP portfolio was discussed. The portfolio has an average life of 34 days. The strategy is to keep short in anticipation of the next fed move which is expected to occur at the Nov. 10 FOMC meeting.

A handout was distributed to committee members describing LGIP month-end balance activity since July 2003. While FY 2005 balances are running about \$250 million less than FY 2004, the pattern of activity is nearly identical. It is anticipated that FY 2005 balance activity will continue to show the same pattern as FY 2004.

continued on page 10

Washington State Local Government Investment Pool
Position and Compliance Report
as of 9/30/2004
(Settlement Date Basis)
(in Thousands)

LGIP Portfolio Holdings

	Cost	Percentage of Portfolio
U. S. Agencies	\$ 24,520	0.55
U. S. Callables	45,000	1.01
U.S. Agency Generic FRN	174,991	3.93
Certificate of Deposit	128,500	2.89
Discount Notes	2,591,306	58.25
Interest Bearing Bank Deposits	115,081	2.59
Repurchase Agreements	1,168,548	26.27
U.S. Treasuries	200,803	4.51
*Total Excluding Securities Lending	4,448,749	100.00

Securities Lending Holdings

Repurchase Agreements	257,226
Total Securities Lending	257,226

**Total Investments &
Certificates of Deposit**

\$	4,705,976
----	------------------

Policy Limitations

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.**

Size Limitations

	Portfolio Holdings	Percentage	Policy Percentage
Total Floating and Variable Rate Notes	174,991	4.00	30%
Variable Rate Notes w/maturities > 397 days	-	0.00	10%
Other Structured Notes	45,000	1.00	10%
Certificates of Deposit	128,500	3.00	10%
Leverage - Sec Lend + Rev Repo	250,992	6.00	30%

Maturity Limitations (Days)

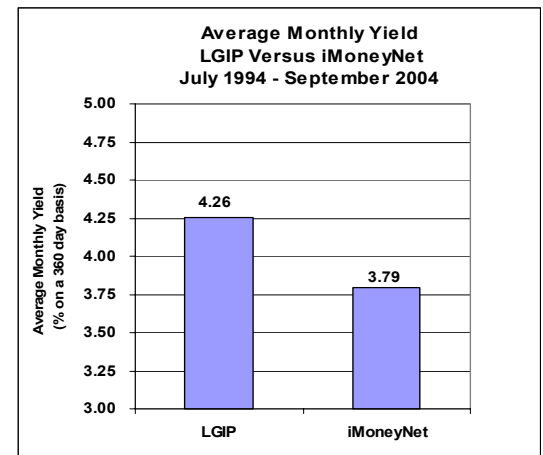
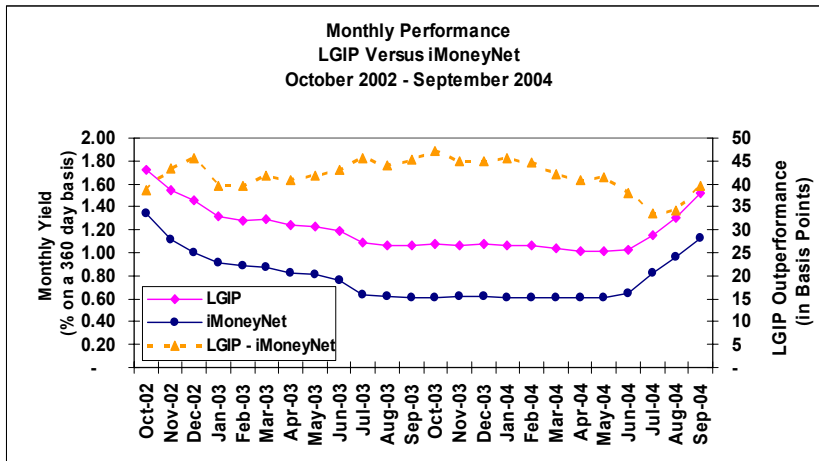
	Currently	Policy
Weighted Average Maturity	35	90
Maximum Final Maturity		
Bullet Securities	396	397
Variable and Floating Rate Securities	501	762
Repos	20	180
Reverse Repos	180	90

Repo Limits Per Dealer

		Total Repo Percentage	Term Repo Percentage	Projected Redemptions	Projected Position
	September 30, 2004	(20% limit)	(10% limit)	10/1/2004	10/1/2004
Banc America Securities	\$ 200,000	4.50%	0.00%	200,000	-
Bear Stearns & Co.	350,000	7.87%	7.87%	-	350,000
Goldman Sachs	350,008	7.87%	4.50%	150,008	200,000
Lehman Brothers Inc.	18,548	0.42%	0.00%	18,548	-
Merrill Lynch	200,000	4.50%	4.50%	-	200,000
Morgan Stanley Dean Witt	307,218	6.91%	4.50%	107,218	200,000
Total	\$ 1,425,774			475,774	950,000

LGIP Performance Comparison

iMoneyNet, Inc.¹ versus Local Government Investment Pool



The chart on the left shows a monthly comparison from October 2002 through September 2004 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to September 2004. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 46.6 basis points. This translates into the LGIP earning \$160.84 million over what the average comparable private money fund would have generated.

¹ Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, Money Market Insight, iMoneyNet, Inc., Westborough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

Minutes from page 8

Sixty-eight percent of all LGIP transactions during the last quarter were made through TM\$. A chart was distributed to committee members showing a comparison of LGIP transactions initiated by TM\$ versus telephone calls. The Pool will be closed on the following dates: November 11, Veteran's Day; November 25-26, Thanksgiving holiday; December 24, Christmas holiday; and, December 31, New Year's holiday.

The FY 2004 and 2005 budget was reviewed utilizing a handout provided to committee members. The fees and overdraft charges col-

lected for FY 2004, in the amount of \$1,767,812 was higher than the original estimate of \$1,404,000 due to a higher than anticipated average daily balance. Expenses for FY 2004 of \$550,925 were lower than the original estimate of \$602,000. Accordingly the rebate for FY 2004, which was \$1,216,887, exceeded the original estimate by \$414,887.

The average balance for FY 2005 is estimated to be approximately \$4 billion. FY 2005 fees and overdraft charges are estimated at \$1,404,000 and the estimate for expenses is \$579,000. The estimated rebate for FY 2005 is \$825,000.

Local Government Investment Pool

STATEMENT OF NET ASSETS

September 30, 2004

(in Thousands)

Assets

Investments, at Amortized Cost:		
Repurchase Agreements	\$	1,168,548
U.S. Agency Securities		2,835,818
U.S. Treasury Securities		200,803

Total Excluding Securities Lending & Securities Purchased But Not Settled		4,205,169
--	--	-----------

Securities Lending Investments, at amortized cost:		
Repurchase Agreements		257,226
Total Investments (Settlement Date Basis)		4,462,395

Due from Brokers - Securities Purchased But Not Settled, at Amortized Cost:		
U.S. Agency Securities		199,604
Total Due from Brokers		199,604
Total Investments (Trade Date Basis)		4,661,999

Interest Bearing Bank Deposits		115,081
Certificates of Deposit		128,500
Cash		1
Interest Receivable		3,750
Total Other Assets		247,332
Total Assets		4,909,331

Liabilities

Accrued Expenses		259
Obligations under Securities Lending Agreement		257,226
Investment Trades Pending Payable		199,604
Total Liabilities		457,089

Net Assets	\$	4,452,242
-------------------	----	-----------

Total Amortized Cost - Settlement Date Basis	\$	4,705,976
--	----	-----------

QUARTER AT A GLANCE

July 1, 2004 to September 30, 2004

(in Thousands)

Total investment purchases:	\$	31,512,960
Total investment sales:	\$	624,139
Total investment maturities:	\$	31,641,821
Total net income:	\$	15,207
Net of realized gains and losses:	\$	1
Net Portfolio yield (360-day basis):		
	July	1.1543%
	August	1.3073%
	September	1.5181%
Average weighted days to maturity:		35 days

WASHINGTON STATE LOCAL GOVERNMENT INVESTMENT POOL
OFFICE OF THE STATE TREASURER
PO BOX 40200
OLYMPIA WA 98504-0200

RETURN SERVICE REQUESTED

PRSRT STD
U.S. Postage Paid
Olympia WA
Permit No. 179



Sunset Building, PO Box 40200, Olympia WA 98504-0200

Toll Free (800) 331-3284 * TDD (360) 902-8963 * FAX (360) 902-9044

Home Page <http://tre.wa.gov>